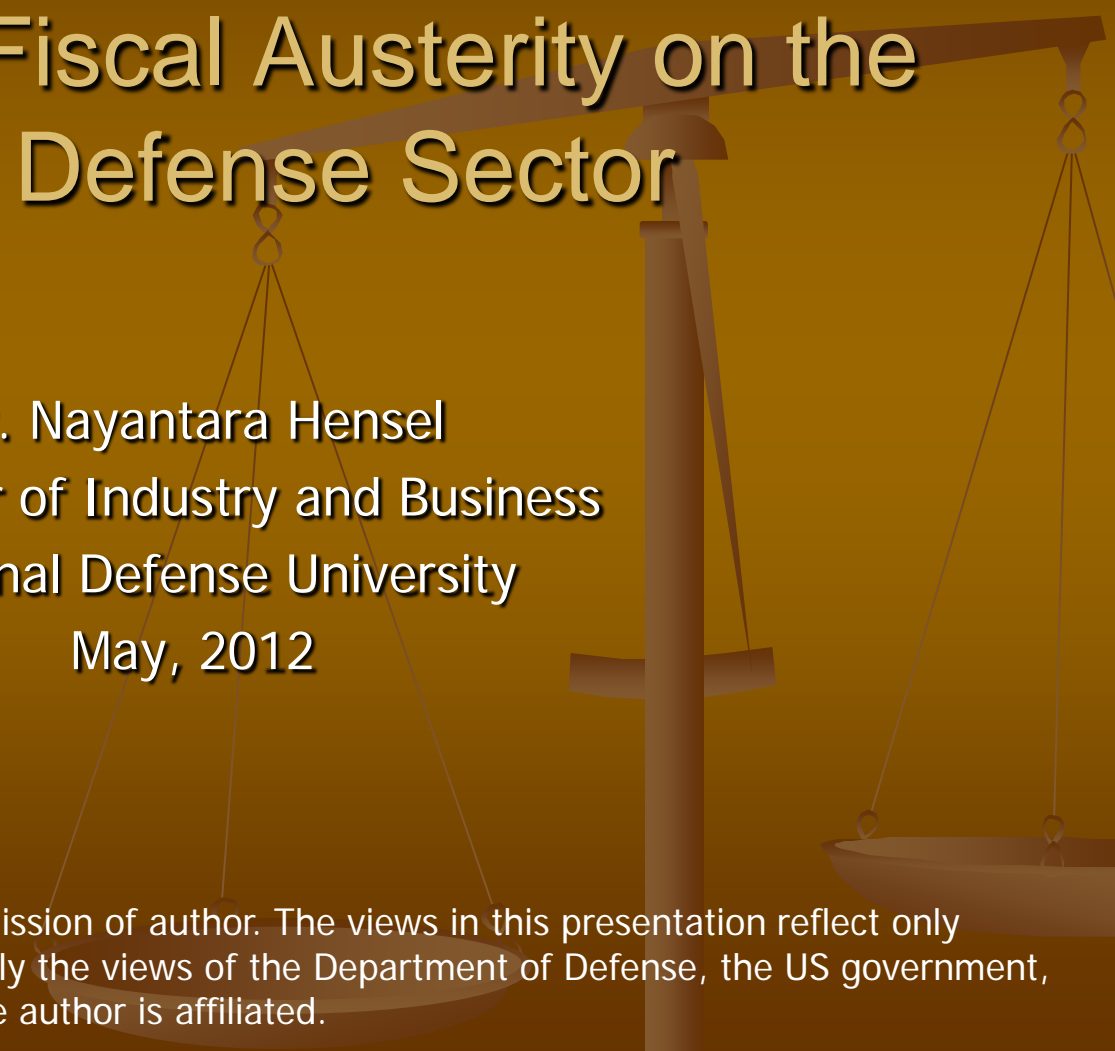


The Impact of Macroeconomic Forces and Fiscal Austerity on the Global Defense Sector



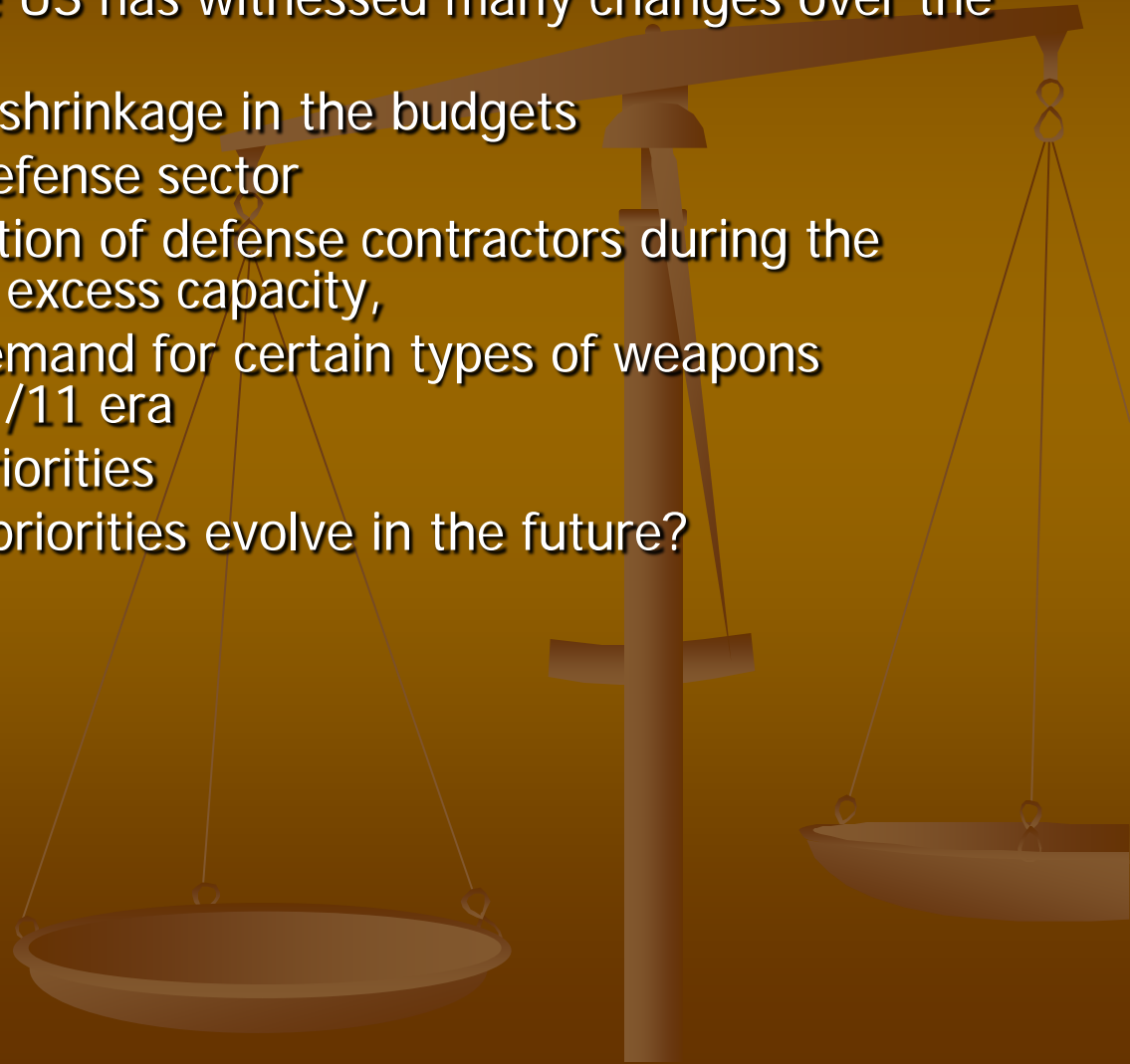
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Evolution of the Defense Sector

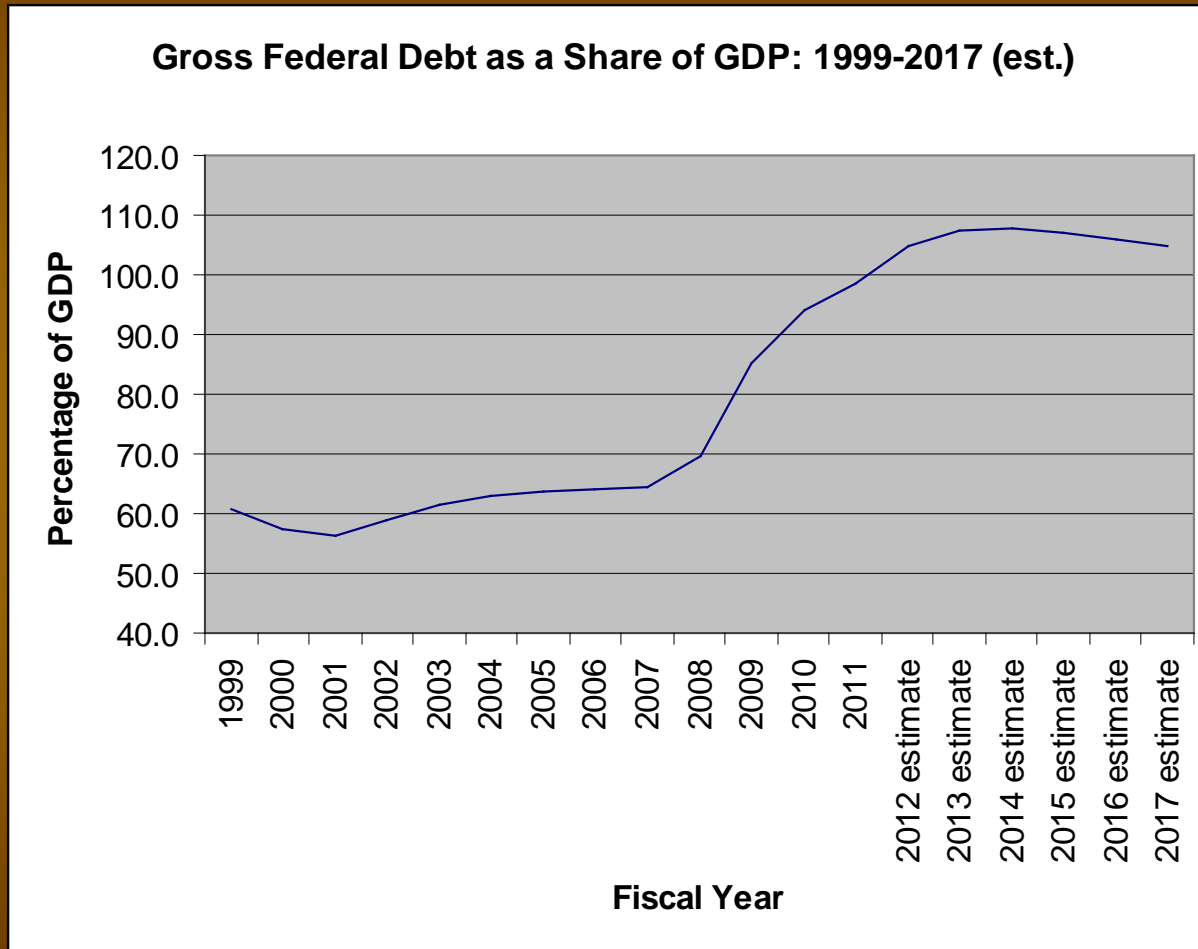
- The defense sector in the US has witnessed many changes over the past twenty years.
 - Cycles of growth and shrinkage in the budgets
 - Globalization of the defense sector
 - Substantive consolidation of defense contractors during the 1990's in the wake of excess capacity,
 - An evolution in the demand for certain types of weapons systems in the post 9 /11 era
 - Shift in defense priorities
 - How will defense priorities evolve in the future?



Outline

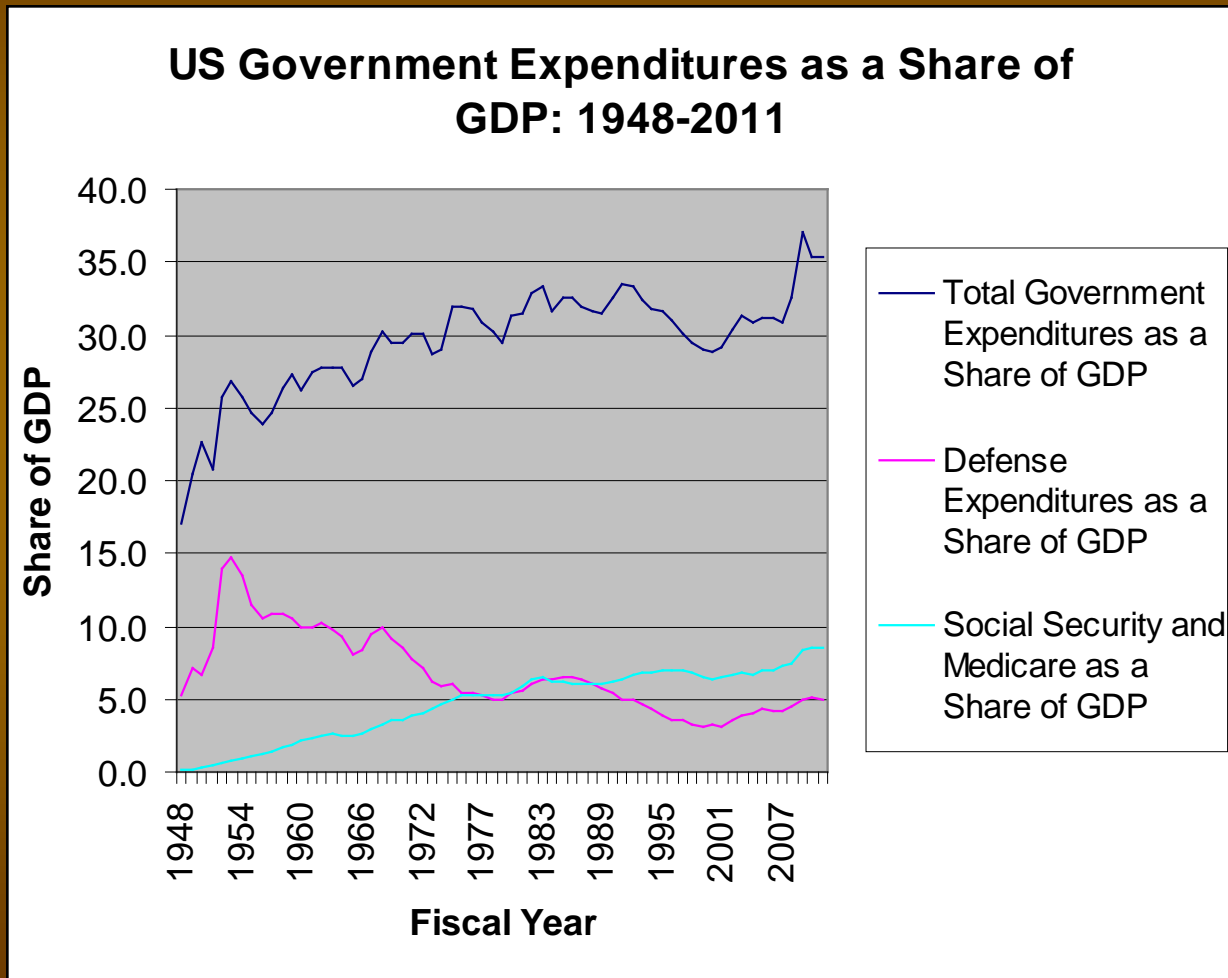
- The macroeconomic / fiscal environment in the US
 - Impact on the US defense industrial base and other areas of the defense budget
- The macroeconomic / fiscal environment in Europe
 - Impact of deepening financial contagion within the eurozone on the European defense industrial base
- The growth in overseas markets as a continued focus of US and EU defense contractors

US Debt as a Percent of GDP



Source of underlying data: Office of Management and Budget

US Government Expenditures as a Percent of GDP: 1948-2011



Source of underlying data: Office of Management and Budget;

US Department of Defense Budget Situation

	2011 Enacted	2012 Enacted	2013 Proposed
Department of Defense Base Budget	\$528.95 billion	\$530.5 billion \$553.02 billion (requested)	\$525.4 billion
Department of Defense OCO Budget **	\$159.06 billion	\$115.3 billion *	\$88.5 billion

*Note that the reduction in OCO funding between FY 2012 and FY 2013 partially reflects OMB's assumption of a complete withdrawal of troops in Iraq in 2013 and a troop level of 68,000 in Afghanistan.

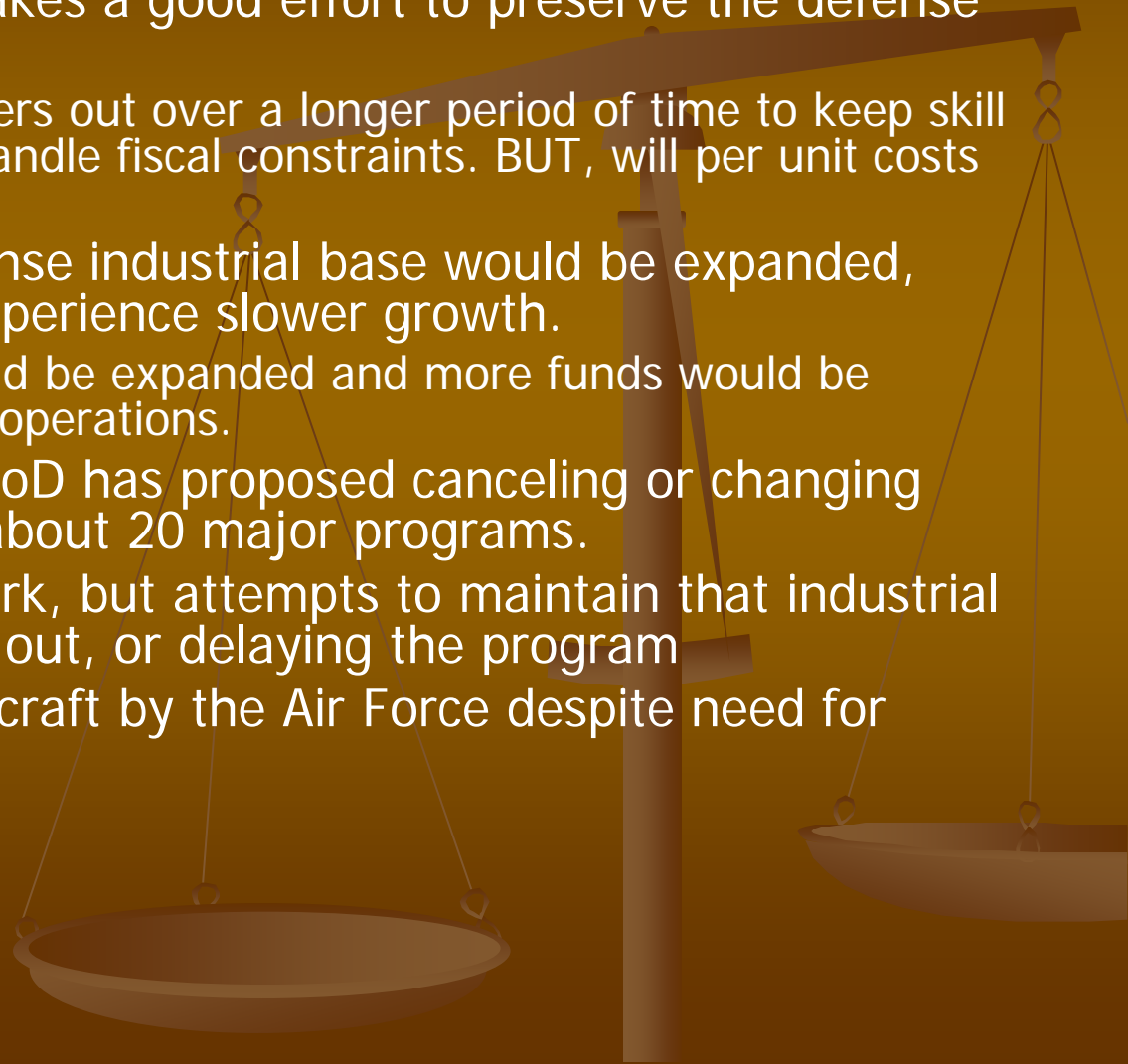
**OMB has directed DoD to move into the base budget by 2014 the budgeting for all "enduring activities" currently in the OCO accounts.

Defense Budget Cuts

- The Budget Control Act, passed in August 2011, calls for \$487 billion in defense cuts over the next ten years.
- Due to the Super Committee's lack of success in developing a blueprint to reduce federal budget deficits by \$1.2 trillion in November 2011, the Budget Control Act calls for sequestration to begin in January 2013, with the Department of Defense bearing \$500 billion of the discretionary spending cuts over the next ten years.
 - This may not occur since Congress could, in the interim, prevent this scenario. The Pentagon has not officially focused on these cuts so far and has rather focused on the mandatory \$487 billion in cuts over the next ten years.
 - Sequestration cuts have not been not built into the February budget submission.
- The Pentagon plans to achieve \$259 billion in cuts over the next five years and has included it in its five year plan attached to the FY 2013 budget request.

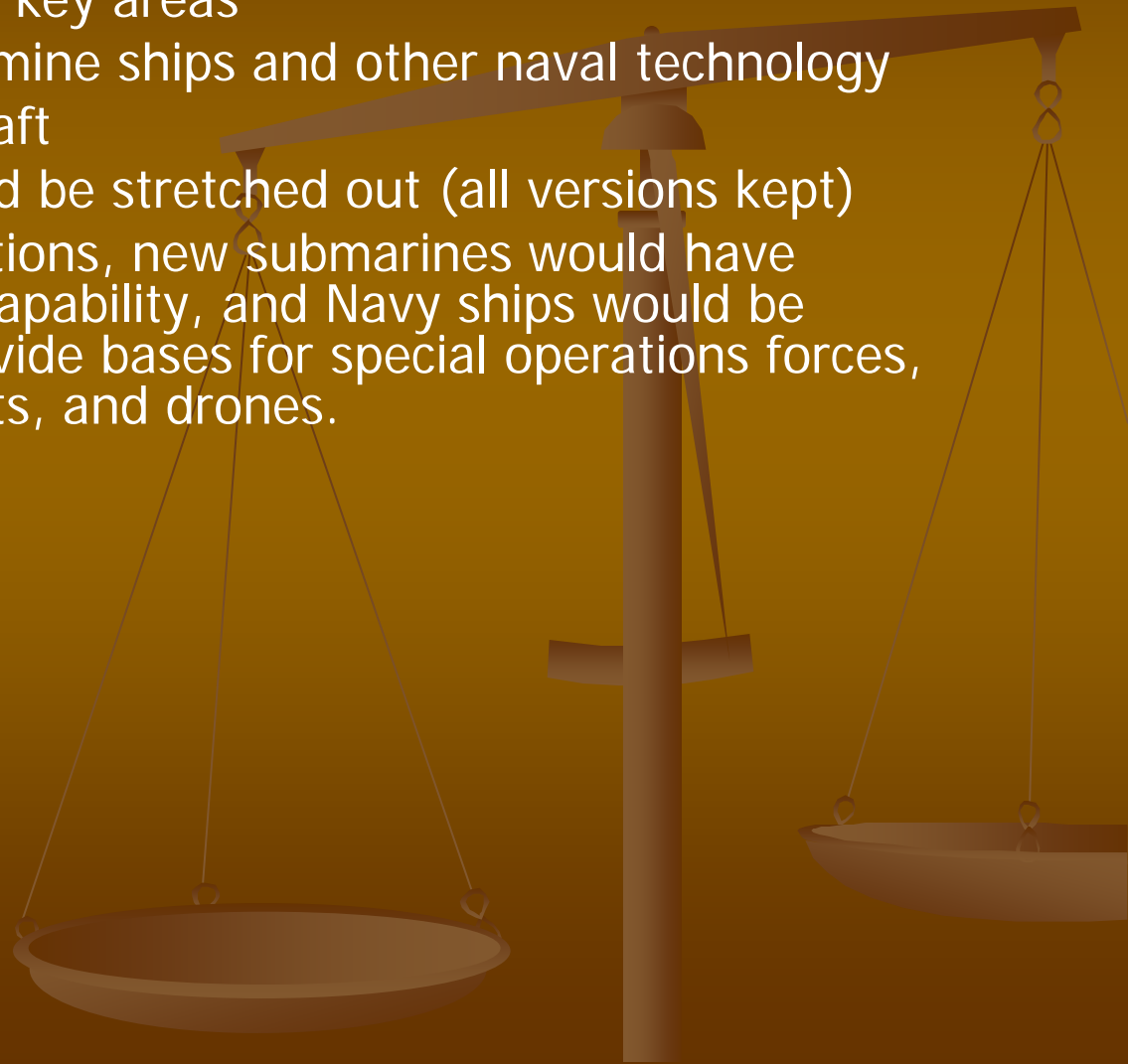
The Defense Industrial Base in the Proposed Budget

- New proposed budget makes a good effort to preserve the defense industrial base.
 - Tendency to spread orders out over a longer period of time to keep skill sets alive, and to also handle fiscal constraints. BUT, will per unit costs increase?
- Several areas of the defense industrial base would be expanded, and other areas would experience slower growth.
 - The fleet of drones would be expanded and more funds would be dedicated toward cyber operations.
- In the FY 2013 budget, DoD has proposed canceling or changing production schedules of about 20 major programs.
- Some loss of shipyard work, but attempts to maintain that industrial base sector by spreading out, or delaying the program
- Reduced purchases of aircraft by the Air Force despite need for modernization



The Defense Industrial Base in the Proposed Budget (cont.)

- Continued design work in key areas
- New investments in anti-mine ships and other naval technology
- Retirement of aging aircraft
- The F-35 purchases would be stretched out (all versions kept)
- Increase in special operations, new submarines would have increased cruise missile capability, and Navy ships would be developed that could provide bases for special operations forces, vertical landing fighter jets, and drones.



European and Asian Defense Markets

- Under the minimum defense investment obligations of the NATO alliance, NATO members must invest at least 2% of GDP in defense.
 - Only three EU-NATO members—Britain, Greece, and France—have met the standard.
 - Recent defense budget decisions in France, the UK, Greece, Germany, and Italy.
 - Likely to significantly impact the EU defense industrial base and skill sets, although greater incentives for jointness.
- As China stakes greater claims in the South China Sea, Australia, Japan, Singapore, and the Philippines have emphasized the need for regional stability.
- The US has been attempting to solidify its presence in the area.
 - “Light footprint” strategy and innovations
- Expansion of other countries’ military equipment in the region to achieve stability
 - Expansion of equipment by the Indian Navy, Vietnam, and Japan.

Concluding Thoughts

- Proposed US defense budget is not significantly lower than enacted FY 2012 budget.
- While DoD has not focused on the \$500 billion in cuts in their projections, it has focused on cutting \$487 billion over 10 years and \$259 billion over 5 years.
- Proposed defense budget attempts to preserve areas of the defense industrial base by slowing development of some systems, while growing other areas.
- Working on developing innovative solutions to mitigate instability in the Middle East and Asia-Pacific areas.
- Other nations are also building their defense arsenal to protect themselves against instability in the Middle East and Asia-Pacific.
- European fiscal austerity is reducing defense expenditures, which may negatively impact the skill base of the European defense industrial base.
- The defense sector will continue to be a significant contributor to the US and global economies. The evolving fiscal environment and the types of military threats will hopefully contribute to the development of a more cost-effective and transparent landscape.